

facilities-based entry; and increased facilities-based entry reduces the costs of resale. The process thereby feeds on itself, promoting competition at both the wholesale and retail levels.

2. Market share trends demonstrate continued decline in AT&T market share.

29. Based on traditional measures of concentration (based on revenue shares), the long distance market would appear to be concentrated with over 80 percent of industry revenues attributable to the top three carriers (AT&T, MCI, and Sprint). However, the market has in fact become increasingly *less* concentrated over time: AT&T's market share has fallen from more than 88 percent to 51 percent between 1984 and 1997.²³ Moreover, this trend has been continuous from 1984 to the present and most of the market share currently being lost by AT&T has been captured by smaller firms other than MCI and Sprint.

30. To put things in perspective, the growth experience of some of the newer competitors such as Excel, Worldcom, or Frontier compares quite favorably with either the MCI or Sprint of a decade ago, indicating that there is no shortage of candidates to offer robust facilities-based competition to today's big three.²⁴ Such life-cycle comparisons are

²³ See Table 8, FCC Common Carrier Bureau, *Long Distance Market Shares*, October 10, 1997.

²⁴ See *Ibid.*

	Revenue Share or Toll Revenues		
	1984:2Q	1996:2Q	1997:2Q
AT&T	88.2%	54.1%	50.8%
MCI	4.7%	17.8%	17.2%
SPRINT	3.0%	8.8%	8.8%

instructive because developing into a full-fledged facilities-based carrier takes time.

3. Price trends demonstrate real declines, net of access reductions.

31. Prices for long distance services have declined significantly since 1984, even after accounting for declines in access charges.²⁵ Figure 3 shows that AT&T's Average Revenue Per Minute (ARPM) for switched interstate toll fell over 60 percent in real terms since divestiture -- and, net of access, prices declined by 37 percent.²⁶ Moreover, these declines were experienced across service categories, and were even larger for some services. For example, Figure 4 shows that between 1990 and 1995, real prices for consumer dial direct, business outbound, and business inbound toll services declined between 24 and 39

WORLD COM	n/a	4.5%	7.0%
OTHER	4.1%	14.7%	16.2%

WorldCom and other carriers captured an additional 4 percent over the past year alone.

²⁵ See *Declaration of R. Glenn Hubbard and William H. Lehr*, note 17, *supra*; *B. Douglas Bernheim and Robert D. Willig*, note 17, *supra*, Chapter 2, pages 68-71; or *True Competition in the Long-Distance Market*, note 17, *supra*, which reports an FCC study which showed that real toll revenue per minute declined \$0.0317 per minute from 1992 to 1995 while real access charges per minute declined only \$0.0132 per minute -- demonstrating that prices declined significantly more than the decline in access charges.

²⁶ This is equivalent to a decline in nominal prices of 45 percent, which is in line with estimates reported by other analysts for long distance toll services overall. For example, Insight Research Corporation reported that prices had declined in the range of 60 percent (see *Telecommunications Without Networks: Resellers, Aggregators, and Rebillers in the U.S. Resale Market*, Insight Research Corporation, December 1994, page 12).

percent, offering benefits to all types of consumers.²⁷ Figure 5 demonstrates that all classes of residential customers -- both high and low usage -- benefited from these price declines.²⁸ Furthermore, the decline in ARPM net of access understates the true magnitude of the benefits delivered to customers because the price declines do not reflect improvements in service quality.

32. Several BOC experts have presented narrow and misleading views of the data attempting to demonstrate a contrary proposition.²⁹ These analyses proceed by selectively choosing individual tariffs or the starting and stopping dates for the time-series, or by relying on flawed telecommunications price indices. A common shortcoming of these studies is a failure to consider adequately the effects of discount programs and other new services on the menu of prices faced by consumers. Because it is a complex task to compare complex baskets of services (*i.e.*, calls which differ by distance, time of day, and enhanced billing and service features), we advocate focusing on the actual prices consumers pay as measured by

²⁷ For example, according to the trade press, prices to corporate business customers declined by 80 percent (see Michael T. Felix, "Preparing the Market for Enhanced Services Implementation," *Telephony*, vol. 230, no. 13, page 40), and today, some large customers are obtaining long distance services for as low as \$0.07 per minute (see David Rohde, "VPN Rates on the Way Down," *Network World* 13 (December 2, 1996) pages 1, 14-15).

²⁸ These data refute allegations by BOC experts that price declines have been narrowly targeted towards a small class of high volume residential users. Today, any residential user need pay no more than \$0.15 per minute for long distance calls, and may actually pay much less depending on the time of the call and the caller's usage patterns.

²⁹ For example, see Paul W. MacAvoy, *The Failure of Antitrust and Regulation to Establish Competition in Long-Distance Telephone Services*, Cambridge: MIT Press (for the American Enterprise Institute), 1996.

the average revenue per minute realized by long distance carriers. When performed on this basis, it is clear that real price declines for long distance services have been substantial; we discuss this in more detail in Section VI below.³⁰

4. Marketing and advertising programs demonstrate vigorous competition.

33. The close causal association between effective competition and the price declines noted above is directly observable from the advertisements and marketing strategies employed by long distance carriers. Each of the major carriers has offered innovative discount pricing proposals, all of which emphasize savings as an important if not the most important inducement to customers.³¹ Although many of these programs are targeted to particular classes of consumers, there are programs for every group. The many residential calling programs (*e.g.*, block-of-time plans, discounts for frequently called numbers, and tie-ins to mileage plans) demonstrate that the benefits of these programs are widely available to all customer segments.³²

34. Furthermore, the pattern of innovation and pricing indicates that there is not a

³⁰ See *True Competition in the Long-Distance Market*, note 17, *supra*, for additional data supporting these same conclusions.

³¹ For example, consider AT&T's "1-800-COMPARE" and MCI's "Proof Positive" programs which allow customers to compare prices directly.

³² According to B. Douglas Bernheim and Robert D. Willig, note 17, *supra*, Chapter 2, page 57: "Industry analysts estimate that, overall, 50 percent of residential users are enrolled in some discount plan, and that these customers account for 75 percent of residential revenues; other estimates place the fraction of long distance customers using discount plans as high as 80 percent."

clear market leader. AT&T has been forced to respond to new programs from MCI and Sprint as often as the other way around, and more important, the smaller reseller firms have often forced the big three to play catch-up. According to some industry analysts, Sprint's move to introduce simplified flat per-minute pricing is motivated both by a desire to respond to consumer demand and to respond more effectively to reseller competition.³³ AT&T has responded with its own "One Rate" plan offering calls for a flat rate of \$0.15 a minute regardless of distance or time of day. In addition, for a \$4.95 monthly fee, it offers a \$0.10 a minute rate at all times. MCI has also responded with a flat rate of 12 cents at all times to customers who make over \$15.00 a month in calls, and it currently offers all residential customers a \$.05 minute rate on Sundays. In turn, Sprint now offers \$50.00 a month of free calls on Monday evenings.

5. Competitiveness of wholesale long distance services precludes market power.

35. The competitiveness of long distance services is further enhanced by structural features of the market. Extensive excess capacity for bulk transport is available from multiple suppliers, which guarantees the existence of competitive wholesale markets.³⁴ The

³³ *Ibid.*, page 65.

³⁴ The FCC has generally concluded that the market for business services is competitive. In 1991, the FCC found the outbound business services market segment to be "substantially competitive" based principally on its findings "that the business services marketplace is characterized by substantial demand and supply elasticities." (See Report and Order, *Competition in the Interstate Exchange Marketplace*, 6 FCC Rcd. 5880, 5887 (1991)). This finding was

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ability to purchase essential inputs in competitive wholesale markets eliminates an important source of potential entry barriers. That is, bulk transport services will be available at efficient, cost-based prices (*i.e.*, at prices that approximate the long-run, forward-looking incremental cost of providing long distance facilities). This outcome, in turn, implies that flexible reseller entry can quickly exploit and eliminate any arbitrage opportunities which may temporarily arise if retail prices rise above efficient, incremental-cost-based levels.

36. The competitiveness of bulk wholesale markets is one of the most potent structural guarantors of effective and aggressive competition for retail services. Moreover, the availability of bulk transport services in wholesale interLATA markets is not comparable to the volume-discounted services offered to high-usage customers in local exchange markets. In long distance, bulk transport may be used as an input to offer a wide array of retail long distance services; it is therefore more akin to the prospective market for unbundled network elements than to that for existing local services. While all of the inputs necessary to offer long distance service are presently available in competitive markets, the same cannot be said for local exchange services.

37. Furthermore, while the Interexchange Carriers (IXCs) actively attempt to differentiate their offerings in terms of discount structures (*e.g.*, AT&T's True USA versus

recently reaffirmed (see *In the Matter of the Motion of AT&T Corporation to be Reclassified as a Non-Dominant Carrier*, 11 FCC Rcd. 3271, 3318 (1995)). The FCC made the same finding with respect to inbound (*i.e.*, 800) services in 1993, once 800 numbers were made portable (see Second Report and Order, *Competition in the Interexchange Marketplace*, 8 FCC Rcd. 3668 (1993)).

MCI's Friends and Family 2) and in terms of quality (*e.g.*, AT&T's True Voice), the focus of retail competition remains on price. Some BOC experts have argued that these attempts favor price collusion rather than price competition.³⁵ They argue that IXC services are relatively homogeneous and that their costs are similar, and that via the tariff process, the IXCs coordinate their pricing decisions to avoid active competition. Putting aside both the fact that such collusion is against the law and that it is contrary to actual experience of long distance competition, arguments for collusion rest on a number of theoretical and factual errors.

38. First, the availability and use of complex discounting programs makes implicit price collusion extremely difficult because the carriers do not observe the acceptance rates for each other's discount programs. Such differentiation is even more extensive in the bulk wholesale services (*e.g.*, long-term contracts and Tariff 12 offerings), which helps assure the competitiveness of retail toll services.

39. Second, while local exchange access costs do comprise a significant share of IXC costs (and reflect a subsidy to BOCs), there are many sources of cost heterogeneity reflecting technological differences and differences in marketing costs.³⁶ These differences are especially relevant for competition in the wholesale markets for bulk bandwidth where specialized facilities-based competition is prevalent.

³⁵ See Paul W. MacAvoy, note 29, *supra*.

³⁶ See B. Douglas Bernheim and Robert D. Willig, note 17, *supra*, Chapter 2, page 49; and Declaration of R. Glenn Hubbard and William H. Lehr, note 17, *supra*.

40. Third, the pattern of similar pricing changes which has been erroneously dubbed "lock-step pricing" is consistent *both* with collusion (as the BOCs claim) and with competition (as all of the other evidence suggests).³⁷ Furthermore, in a competitive environment, similar moves in the tariff for basic rate services can be explained easily as a rational marketing response necessitated by the need to avoid confusing consumers who are attempting to evaluate alternative discount programs. Consider the marketing problem of selling in the presence of a competitor who offers a larger discount (on which consumers are most likely to focus) from a generally higher basic tariff (which few consumers ever read). Because the principal competitive efforts of the IXC's are focused on differentiating their products via discount or enhanced-service offerings, these offerings ought to be the focus of an analysis of pricing behavior.³⁸

41. Fourth, the alleged success of AT&T, MCI, and Sprint to collude on prices to earn excess margins would provide a potent inducement for expansion by existing competitors such as Worldcom, Excel, or Frontier, and would attract new entry into the market (for example, from out-of-region BOCs, CAPs, or cable television carriers).

³⁷ For example, common cost shocks should elicit similar pricing responses under many market structures.

³⁸ As we noted earlier, this point explains why simplistic comparisons of tariff schedules should be avoided. A better measure of pricing trends is provided by comparing average revenue per minute trends, which reflect the weights of actual market demand, rather than arbitrary weights selected to support an advocacy analysis. Furthermore, higher basic rate service is likely to encourage accelerated migration to the new service offerings which is in keeping with the desire of IXC's to differentiate their products.

42. To summarize, the structural features of long distance services encourage aggressive competition.

43. This competitive situation is quite different from that in local exchange markets. In local markets, almost all of the capacity is controlled by a single carrier. Today, with the BOC entry restriction into in-region, interLATA services in effect, the BOCs have an incentive to provide non-discriminatory access services to all long distance carriers. As we discuss further below, this incentive disappears once the BOC becomes a long distance competitor. The recent behavior of Southern New England Telephone Company (SNET) and GTE illustrates this phenomenon. AT&T has filed a complaint against SNET for its discriminatory behavior marketing its long distance services in Connecticut,³⁹ and GTE has been delaying interconnection negotiations with AT&T, severely hindering AT&T's ability to provide local service.⁴⁰

6. Customer switching among carriers demonstrates consumer sovereignty.

44. Potent evidence of consumer sovereignty is provided by the pace with which

³⁹ See *Petition of AT&T Communications of New England, Inc. for Review of the Southern New England Telephone Company's Local Office and Other Practices*, filed September 9, 1996, Docket No. 96-09-05. The anticompetitive behavior of SNET is discussed further, *infra*, at Section V.A.

⁴⁰ See *Direct Testimony and Exhibits of Russell D. Morgan on Behalf of AT&T Communications of the Southwest, Inc. in connection with SOAH Docket No. 473-96-1191, PUC Docket No. 15711 (Complaint of AT&T Communications of the Southwest, Inc. Against GTE Southwest, Inc., et al.)*, page 28.

customers shift among long distance service providers. This provides a better measure of the level of competitiveness of a market than a simple comparison of overall market shares. For example, AT&T experienced 19 percent churn in 1992, and over 42 million long distance subscribers changed carriers in 1995.⁴¹ The rate of churn rose further still in 1996, with 53 million customers changing carriers.⁴²

45. To summarize, available evidence points to the conclusion that competition in long distance services is quite vigorous.

B. Competition in Local Exchange Markets

1. Lack of present competition in local exchange markets

46. Consideration of similar data used to evaluate the competitiveness of long distance markets yields a starkly different conclusion: Markets for local exchange are not competitive presently. With the exception of a few niche markets, customers can purchase local exchange services from only one firm. The BOCs have a *de facto* monopoly that grants them significant market power over facilities that are essential for competition in both long distance and local telephone markets. In BellSouth's service territory, BellSouth provides all

⁴¹ See B. Douglas Bernheim and Robert D. Willig, note 17, *supra*, Chapter 2, page 67. The 19 percent churn statistic is based on the share of AT&T revenue associated with customers who either left AT&T for another carrier or vice versa.

⁴² Based on estimates provided by AT&T.

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but 2,400 access lines.⁴³ It is therefore safe to assume that BellSouth controls more than 99% of the total access lines in its service area.

47. In contrast to prices for long distance services, prices for local services have increased -- even after adjusting for the reduction in access charge revenues collected from the long distance providers (see Figure 6).⁴⁴ According to a recent study by the Consumer Federation of America, the ILECs are "earning \$4.5 billion annually in charges resulting from excess profits at the expense of captive telephone ratepayers."⁴⁵

48. This study goes on to show that local phone rates have increased in recent years, despite the fact that the overall cost of providing service has been declining.⁴⁶

⁴³ *Affidavit of Gary M. Wright on Behalf of BellSouth*, in the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-region, InterLATA Services in South Carolina, Before the Federal Communications Commission (October 1997), ¶ 24.

⁴⁴ The data in Figure 6 show that the Producer Price Index (PPI) for local services has risen 43 percent while the PPI for MTS and WATS fell 23 percent and 32 percent, respectively, from 1983 until 1995. Moreover, this relative disparity is understated because the PPI inadequately accounts for discount programs which are much more important in long distance services than in local services.

⁴⁵ See "Study Finds \$4.5 Billion in Annual Excess Profits for Local Monopoly Telcos," Press Release from Consumer Federation of America, September 18, 1996, page 1. The press release summarizes results from a report by Mark N. Cooper, "Excess Profits and the Impact of Competition on the Baby Bells," Prepared for the Consumer Federation of America, Washington, D.C., September 1996.

⁴⁶ The study concludes by stating: "The pressures put on regulators by the Baby Bells is certain to be vigorous, but the evidence is compelling that if regulators do the right thing, the initial impact of competition will be to restore Baby Bell profits to reasonable levels and create

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Monopoly profits support cost inefficiencies⁴⁷ and provide the RBOCs with a war chest from which to fund anticompetitive activities. To quote BellSouth:

"[T]he dominant incumbent, if it fails to accept the benefits which flow from a competitive market, can and will rationally use interconnection negotiations to delay and restrict the benefits of competition.....A dominant incumbent can limit both the scale and scope of its competitors, raising their costs and restricting their product offerings. In addition, it can divert or delay competition and innovation to protect its current revenues..."⁴⁸

a level playing field for competition." See Mark N. Cooper, note 45, *supra*.

⁴⁷ According to BellSouth, "monopoly-bred inefficiency plays into the incumbent's hands by (1) enabling dramatic improvements in operating results through relatively easy 'fatcutting,' and (2) justifying high interconnection prices designed largely to recoup the incumbent's past inefficiencies" (see *Comments of BellSouth Europe to the European Commission's Green Paper on the Liberalization of Telecommunications Infrastructure and Cable Television Networks*, BellSouth Europe, March 15, 1995, page 5).

⁴⁸ See *Regulation of Access to Vertically-Integrated Natural Monopolies*, discussion paper, BellSouth New Zealand, September 1995, page 2. Later the same report argues that it is rational for the incumbent:

"to exploit the regulatory regime to the greatest possible extent without exposing itself to the threat of intervention or adverse changes to the regime. In fact, the directors of the dominant incumbent have a fiduciary duty to seek to extract the highest rents available to it as a result of its business position (as does any other profit-maximizing firm).....It has very powerful incentives to include monopoly rents in the price of complementary network services in order to perpetuate and increase its monopoly profits. It similarly has powerful incentives to reduce the ability of its competitors to claim market share."

Id., page 10.

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49. In recognition of their dominant position, BOCs such as BellSouth are subject to substantial regulatory oversight from state commissions and the FCC. This ranges from traditional rate-of-return regulation in some states to more indirect forms of oversight in other states. The Telecommunications Act of 1996 anticipates the eventual deregulation of all telecommunications services, once effective competition makes regulatory oversight unnecessary.

50. CAPs such as Metropolitan Fiber Systems (MFS) and Teleport typically have aggressively competed for the particular services of a segment of customers in a subset of markets. These are principally the access services demanded by large commercial customers in major metropolitan areas, and most often located in large office buildings. To the extent they are now seeking to provide service as CLECs as well, they are largely pursuing the same limited customer base. Therefore the CAPs are irrelevant to the vast majority of customers in most markets, most particularly residential customers.⁴⁹

51. Even if the CAPs' market focus were broader, their physical capacity is both too small and too limited in geographic coverage to handle more than a small subset of BOC

⁴⁹ The CAPs' principal market opportunity has been to provide special access (*i.e.*, dedicated access) and private line services in many cases to long distance carriers to interconnect their points of presence (POP) and the BOCs' switching centers. This has been feasible because these are the services which depend least on cooperation of the BOCs and rely least on the BOCs' facilities. Therefore, CAPs are less vulnerable to anticompetitive practices by the BOC.

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traffic.⁵⁰ Accordingly, the presence of CAPs in certain areas does not constrain BOC monopoly power or the BOC's ability to engage in leveraging.

52. The opening of local exchange markets to effective competition as anticipated by the Act will encourage innovation and the further development of local exchange technologies. Two areas may be promising. First, telephony services may be added to existing non-telephone wireline networks (*i.e.*, cable television or electric utility networks). Second, there are a number of wireless technologies such as PCS which may provide an alternative technology platform for offering local exchange services. While both may provide promising avenues from which *future* competition may emerge, they remain commercially unproved technologies at this point. Therefore we cannot rely on these technologies to restrain BOC market power today.

53. Overlaying telephony services on an existing cable television or electric power network presents a number of important challenges. First, there is no generally available technology for providing telephony over cable or electric networks. Second, there has been no history of direct telephony experience. Third, there are significant costs associated with retrofitting these networks to support telephony. There is no general agreement among analysts about the optimal strategies and costs for effecting these upgrades. Fourth, in the

⁵⁰ According to B. Douglas Bernheim and Robert D. Willig, note 17, *supra*, Chapter 3, page 10, the CAPs deployed 700,000 network fiber miles of transmission capacity in 1995, compared to the LECs' more than 8 million fiber miles and well over a billion miles of copper cable. In 1995, there were only 9,000 buildings on CAP networks nationwide. See B. Douglas Bernheim and Robert D. Willig, note 17, *supra*, Chapter 3, page 11.

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case of cable television, many carriers have a poor reputation for service quality which would need to be remedied before these firms would be credible as viable telephony competitors. Fifth, as the dominant providers of local television entertainment services, cable television providers may have an incentive to adopt a strategy of mutual forbearance wherein they stay out of telephony with the implicit understanding that the BOCs stay out of television services.

54. Wireless technologies may offer more future potential, but they raise a significant number of technical issues. The chief selling point to date for wireless services has been mobility. Such service is a *complement*, not a *substitute*, for fixed wireline local telephone service. Wireless service commands significantly higher prices as a premium service, despite the generally inferior quality of wireless telephone relative to wireline service. Furthermore, important technical disagreements over what standards to use (*e.g.*, CDMA or TDMA) need to be resolved.

2. Sources of difficulty introducing local exchange competition

55. To compete in local exchange services, an entrant must rely on the cooperation of the monopolist BOC -- in this case, BellSouth. At the very least, an entrant will need to interconnect to the BOC's facilities in order to exchange traffic between callers on the entrant's network and the BOC's. Moreover, as recognized by the Act, it is neither feasible nor efficient for an entrant to replicate all of the facilities of the BOC in order to provide service. Therefore the BOC is required by the Act to offer for sale both UNEs and

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wholesale versions of its retail services. For entry to be feasible, an entrant needs to be able to lease essential monopoly inputs on a flexible basis from the BOC. If these inputs are priced at efficient levels, then the entrant will be able to make the correct "make versus buy" decisions and will invest in facilities only when such investment is efficient.

56. Obviously, an entrant that is willing to focus narrowly on special access or private line services is less dependent on the cooperation of the BOC, and hence less vulnerable to anticompetitive behavior. Broad entry into local exchange services of the sort anticipated by AT&T requires entry into switched services and thereby depends on the full cooperation of the BOC. A BOC is unlikely to cooperate willingly because competition threatens its dominant market position. It would prefer to maintain its monopoly over local services and be granted opportunities to expand into other services without having to face any regulatory constraints. This preference is simply consistent with profit-maximizing behavior. The Act and the FCC's Order clearly recognized the necessity of a legal mandate if a BOC such as BellSouth is to cooperate with entrants.⁵¹ Indeed, if such legal mandates were unnecessary, the Act would have been unnecessary.

⁵¹ The FCC's Order notes that "[a]n incumbent LEC ... has the ability to act on its incentive to discourage entry and robust competition by not interconnecting its network with the new entrant's network or by insisting on supracompetitive prices or other unreasonable conditions" (see paragraph 10 of the *First Report and Order*, In the Matter of Implementation of Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Released August 8, 1996, hereafter referred to as *First Report and Order*). Moreover, the FCC recognized that the BOCs possess superior bargaining power and that a new entrant "comes to the table with little or nothing the incumbent LEC needs or wants" (see *First Report and Order* ¶ 15).

57. There are many price and nonprice strategies which a BOC can utilize to directly or indirectly hinder the emergence of effective competition. The price strategies are only the most obvious: If the prices charged for essential inputs are above efficient levels, then entry will be deterred. The BOC has an incentive to misrepresent cost data and to misallocate costs in order to induce regulators to set prices for UNEs, interconnection and wholesale services which are too high. The BOC has an incentive to seek to restrict the range of services and UNEs which entrants may purchase and to argue for inefficient surcharges (*e.g.*, to subsidize its carrier-of-last-resort obligations or to recover historical costs) in order to force prices above efficient levels.

58. In addition to the pricing strategies suggested above, the BOCs can avail themselves of a wide range of nonprice strategies which are often more difficult to detect and deter. Entry into local exchange services is difficult because it requires a huge investment and depends on cooperation from a hostile competitor. While the Act provides the public policy framework for addressing these issues (in the Section 251 requirements), implementation of these rules will be difficult.

59. Economists have identified several price and nonprice strategies which may be employed by a monopolist such as a BOC to exploit, extend, and protect its market power. First, a monopolist can exploit its market power by setting high prices, generally well above costs. Moreover, a monopolist chooses the range of products to offer based on what maximizes profits for the monopolist, not what consumers most want. In some cases, this

results in poor quality (because consumers have no choice but to accept what the monopolist offers) or in other cases, excessive investments in features which appeal to only a subset of customers but for which the monopolist can force all customers to pay (*e.g.*, investments in broadband services). Traditionally, regulators have attempted to control these activities by setting quality standards, by determining what capital investments are allowed into rate base, and by setting prices for retail services -- and by restricting the monopolist's participation in competitive markets (*e.g.*, long distance services) to protect those markets and to limit the monopolist's ability to circumvent regulatory controls. However, such control is imperfect because the monopolist BOC possesses superior information regarding the actual nature of its costs and consumer demand.

60. Second, a monopolist may seek to extend its market power by "monopoly leveraging." That is, a monopolist in one market may seek to extend its power to another related market, which is most easily accomplished when the monopolist controls an essential input in the second market. By tying or bundling the purchase of the goods in the two markets, the monopolist can extend its power over both markets. For this reason, the courts have often acted as if there is a *per se* restriction against tying where the firm has market power, in spite of the fact that more recent economic theory suggests that there can be efficiency-based motivations for tying and that the circumstances under which this is the preferred mechanism for extending monopoly power are limited. However, tying is likely to be attractive as a mechanism for avoiding rate regulation (*e.g.*, if the essential input is

subject to a price ceiling that limits the BOC's ability to extract profits from its sale).

61. Third, and perhaps most likely, a monopolist is likely to seek to protect its market position by "raising its rivals' costs," a generic expression for a whole class of price and non-price predation and foreclosure strategies.⁵² The BOC can potentially raise an entrant's costs by manipulating any of the price or non-price terms associated with the essential inputs which the entrant requires to effectively compete in the market (*e.g.*, interconnection services, UNEs or wholesale versions of retail services). In addition, BellSouth can provide inferior-quality service unless regulators are vigilant and contracts regarding interconnection, UNEs, and wholesale services are suitably specific in their requirements.

62. Alternatively, a BOC may seek to create "customer switching costs" in order to make it more difficult for an entrant to attract new customers -- for example, anything

⁵² An upstream monopolist (*i.e.*, the BOC which controls local exchange access) generally will have an incentive to discriminate against downstream rivals (*i.e.*, interLATA competitors) as explained in recent papers by Nicholas Economides (see Nicholas Economides, "The Incentive for Non-Price Discrimination by an Input Monopolist," Mimeograph, Stern School of Business, New York University, January 1997) and by Randolph Beard, David Kaserman and John Mayo (see Randolph Beard, David Kaserman and John Mayo, "Regulation, Vertical Integration and Sabotage," Mimeograph, University of Tennessee, January 1997). The findings of these stand in contrast to the result proposed in a recent working paper by David Sibley and Dennis Weisman (see David Sibley and Dennis Weisman, "Competitive Incentives of Vertically Integrated Local Exchange Carriers: An Economic and Policy Analysis," *Journal of Policy Analysis and Management*, vol. 17 (1997). Sibley and Weisman err by assuming that the downstream (interLATA) subsidiary of the BOC maximizes its own profits and fails to take account of the consequences of its decisions for the profits of the integrated company. Such an assumption is inconsistent with rational value maximization.

which damages the reputation of the new entrant (*e.g.*, poor-quality service due to slow delivery, maintenance or repair, or noisy local loop facilities), makes it difficult for a customer to learn about new entrants (*e.g.*, misleading advertising by the BOC), or makes it difficult for a customer who wishes to change suppliers to actually do so (*e.g.*, cumbersome procedures for effecting the transfer of customers to a new local service provider).

3. Indirect strategies for frustrating competition

63. The preceding discussion highlight some of the more obvious direct strategies which may be employed to hinder progress towards effective competition.⁵³ There are also many indirect strategies which can be as effective in slowing the emergence of local exchange competition. These indirect strategies are even harder to detect and hence even more difficult to deter.

64. The emergence of local competition is likely to encourage the development of new and innovative products and services which will further complicate what is already a very complex marketplace. The BOC will likely engage in a wider array of markets of varying degrees of competitiveness and subject to varying degrees of regulatory oversight. Therefore, preventing cross-subsidization and other attempts to circumvent regulations by actions taken in unregulated markets will become more difficult.

⁵³ See also the more extensive discussion in B. Douglas Bernheim and Robert D. Willig, note 17, *supra*, Chapter 4.

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65. Moreover, the possibility, on occasion, of an "efficiency" rationale for strategies that have anticompetitive consequences provides the BOC with ample opportunities to deny plausibly that a particular strategy is being employed for anticompetitive purposes. In the face of rapid technological progress, it may be impossible to reverse the damage caused by the strategy if regulators wait until the damage becomes evident. Even if the BOC were enjoined from using the anticompetitive strategy in the future, new versions of such strategies can be used, and the BOC has the first-mover advantage of being able to decide when and how to move.

66. Four classes of examples illustrate some of the strategies. First, because an entrant requires the BOC's cooperation in order to arrange interconnection, purchase UNEs, and resell wholesale services, the BOC can devote insufficient resources to the task of sustaining this cooperation. The promotion of competition will require active cooperation by the BOC; its neglect or slow response time, therefore, can be quite effective at thwarting competition.

67. Second, the BOC may exploit its ability to discriminate selectively. Because the BOC controls the timing, design, and scope of its facility upgrades and the services it offers, it can manipulate these activities strategically to affect rivals differentially. It will be quite difficult to prove that a BOC delayed implementation of a feature required by an entrant because it wished to harm the entrant as opposed to its technical or other inability to respond sooner. Alternatively, a BOC can choose the level of quality which it offers to all

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entrants in such a way as to harm particular entrants selectively. For example, the BOC may argue that it is implementing a minimal functionality, "lowest common denominator" systems interface in order to avoid discriminating against limited-capability entrants when the real motivation is to deny access to increased functionality to more threatening competitors.

68. Third, seemingly "nondiscriminatory" quality degradation can be discriminatory in the following important sense: Entrants to local exchange services must establish a reputation for quality in order to attract customers, and a reduction in overall quality that coincides with the onset of competition would increase the difficulty of acquiring such a reputation. Similarly, local service quality problems which can be assigned to the onset of competition will mislead consumers regarding the benefits of competition and may make it more difficult for state commissions to implement the requirements of the Act. Finally, a reduction in quality could damage the investments of long distance carriers in their reputations for quality service, narrowing any consumer perceptions that long distance carriers offer better service than the BOC.

69. Fourth, while the Act requires the BOC to cooperate, the Act is quite complicated and its provisions and requirements are unlikely to be fully understood by the ILEC's employees. An ILEC does not need to tell its employees to be uncooperative or to try to mislead customers about the likely impact of competition. Indeed, many of the employees may decide to behave in this way on their own. The BOC's employees are likely to associate the onset of competition with increased job insecurity and the language of healthy

business competition often characterizes competitors as "the enemy." Therefore, by failing to devote adequate resources to supervising or educating employees of their obligations under the Act, FCC regulations and arbitrated decisions, a BOC may be able to implement a decentralized, anticompetitive strategy or have it implemented on its behalf by its employees. This is especially difficult to protect against because it does not require centralized coordination; there does not need to be a smoking gun.

70. Whether the ILEC uses neglect, fails to supervise workers adequately, strategically chooses "nondiscriminatory" service standards so as to harm competitors, allows overall quality to degrade, mobilizes opposition to competition, or other anticompetitive strategies, the effect will be the same: *Progress toward effective competition will be slowed.*

4. Ample evidence that BellSouth has behaved so as to hamper progress of local competition

71. The best evidence of this incentive and ability to hamper competition for local exchange service is BellSouth's failure to comply with the Act.⁵⁴ For example, BellSouth has filed an SGAT that expressly provided that vertical features were available only as resale services, despite the Commission's ruling that vertical features are included within the unbundled local switch and its rejection of the argument that such features could only be purchased as retail services.⁵⁵

⁵⁴ See generally the affidavits of James Carroll, Jay Bradbury, Patricia McFarland and Kenneth McNeely, filed herewith.

⁵⁵ McNeely Aff., ¶¶ 12-16.

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72. In addition, BellSouth ignored the Commission's rules that required incumbent LECs to allow CLECs to purchase combinations of unbundled network elements at cost-based rates, and that prohibited incumbents from separating "requested network elements that the incumbent LEC currently combines." 47 C.F.R. § 51.315(b). In the face of these rules, BellSouth filed and obtained approval of an SGAT that offered combinations of unbundled network elements at wholesale, rather than cost-based, rates.⁵⁶

73. BellSouth is also thwarting local market entry through total service resale by restricting the resale of contract service arrangements ("CSAs"). Indeed, the FCC expressly rejected BellSouth's previous arguments that contract offerings should be exempt from the wholesale discount requirements and the Eighth Circuit upheld the FCC's findings.⁵⁷ Nonetheless, BellSouth's SGAT provides that the statutory discounts "do not apply" to contract service arrangements.⁵⁸ BellSouth's restrictions effectively insulate large portions of the market from resale competition, because BellSouth has entered into CSAs with many

⁵⁶ McNeely Aff., ¶¶ 12-16. Although the Eighth Circuit recently granted petitions for rehearing with respect to the Commission's regulation relating to the obligations of ILECs to combine unbundled network elements, this decision in no way alters the fact that BellSouth filed an SGAT that clearly conflicted with binding Commission regulations.

⁵⁷ *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, ¶ 948 (1996); *Iowa Utilities Bd.*, 120 F.3d at 819.

⁵⁸ SGAT § XIV.B ("BellSouth's contract service arrangements are available for resale only at the same rates, terms, and conditions offered to BellSouth end users.").

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larger businesses (and indeed has increased its use of CSAs recently).⁵⁹ These restrictions are anticompetitive.

74. BellSouth's anticompetitive conduct in response to the prospect of fledgling local competition is not surprising, in light of BellSouth's similar efforts to forestall the development of intraLATA competition after it was ordered by the South Carolina Public Service Commission.⁶⁰ In 1993, as part of an offering called "Calling Area Plus," BellSouth entered into an industry stipulation under which all carriers, interexchange carriers and LECs, would pay the same terminating access charges to the LEC that completed intraLATA toll calls.⁶¹ However, as AT&T later discovered, BellSouth had entered into a side agreement with certain independent LECs, under which the LECs charged each other lower access charges than they were charging competing interexchange carriers.⁶² When the deal was exposed, BellSouth was forced to enter into a new stipulation giving IXC's more favorable treatment.⁶³

⁵⁹ See McFarland Resale Aff., ¶¶ 28-36.

⁶⁰ South Carolina Pub. Serv. Comm'n Order No. 93-462. Before the South Carolina PSC ordered intraLATA competition, BellSouth opposed efforts to open that market to competition, see, e.g., Georgia IntraLATA Competition Task Force Report, Docket 531194 (March 1, 1995), and even opposed services such as SDN and MegaCom that could incidentally be used to complete such calls, see Louisiana Pub. Serv. Comm'n Docket Nos. 17578, 17644, 17767.

⁶¹ *Ibid.*

⁶² See Attachment 3 hereto.

⁶³ South Carolina Pub. Serv. Comm'n Order No. 94-342, Docket No. 93-176-C (April 14, 1994).